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A LOOK AT THE LUXURY RETAIL INDUSTRY: FINANCIAL ANALYSIS
AND ADVISORY RECOMMENDATIONS FOR TIFFANY AND COMPANY

by
Ellen Valle

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of
the requirements of the Sally McDonnell Barksdale Honors College.

Oxford
May 2016

Approved by

Advisor: Dr. Victoria Dickinson

ABSTRACT

ELLEN VALLE: A Look at the Luxury Retail Industry: Financial Analysis and Advisory
Recommendations for Tiffany and Company
(Under the direction of Victoria Dickinson)

This thesis investigates Tiffany and Company, a premier jewelry retailer that is traded on the New York Stock Exchange. Company financial statements, as well as external non-company provided sources, were used as data to evaluate the company's performance, as well as reach a holistic understanding of the company's operations and financial reporting.

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Introduction

Purpose of course

This ACCY 420 course, which comprised of two semesters, was designed to assist with the thesis development process. During the first semester of the course, my classmates and I heard from representatives from both industry and accounting firms, who were able to give us some insight into the accounting field, the different industries, and some of the current issues accountants face. As well, the representatives provided us with some helpful career preparedness tips. As the semester progressed, we were able to get a better idea of what type of company we wanted to select to research for our thesis. The second semester was the culmination of the course, during which our research was performed and thesis was written. The course included information about research methods and practice related to financial statement analysis and equity valuation.

Purpose of assignment and skills gained

The purpose of this assignment was to get to get an in-depth perspective of a company through evaluation of their annual reports and other available literature on the company. As well, the assignment required translation of concepts learned in the classroom to actual situations. Furthermore, material covered in coursework was oftentimes taken to the next level. Additionally, I feel that this assignment has

taught me the fundamentals of professional research and has allowed me to become much more comfortable and familiarized with going through 10-Ks and other company filings. Finally, I feel that developing this thesis has allowed me to improve my ability to think critically.

Chapter 1: General Company Information

Company History

Tiffany & Company's story begins in nineteenth century New York City. On September 14, 1837, Charles Lewis Tiffany, along with his childhood friend, John F. Young, established a small stationery and gift shop with \$1,000 he had borrowed from his father. The 258 Broadway shop had humble beginnings, only bringing in \$4.38 of revenue during its first week of business, but experienced growth during its first few years of operations and eventually expanded its merchandise offerings to include glassware, porcelain, cutlery, clocks, and jewelry. The store featured plainly marked prices that were strictly adhered to, sparing the customer the usual practice of haggling with the proprietor. They also departed from the norm by requiring cash payment rather than allowing purchases on account or accepting barter (IDCH). In 1841, the store took on a third partner, J.L. Ellis. The new partner's capital enabled Young to travel to Paris as a buyer. The store eventually opened a branch there. In the late 1840s, due to political upheaval across Europe, the price of diamonds from European brokers plummeted. Charles Lewis Tiffany took advantage of this opportunity and invested heavily in precious stones. With this acquisition, the shop became primarily a jeweler. The store, which reorganized under the name Tiffany and Company after Charles Lewis bought out the other two partners, continued to

experience growth and by the this time had secured its reputation as a luxury retailer.

When hostilities arose between the American North and South, Tiffany foresaw a drop in demand for fine jewelry in a nation at war, and diverted the company's investments to military equipment, including swords, medals, rifles, ammunition and light armor. During the Gilded Age that followed, Tiffany's main problem was not selling jewelry, but finding enough to satisfy the demand. In 1868, Tiffany's opened a London branch and was officially incorporated. Around this time, the New York store moved to a newly constructed location on Union Square. Tiffany's prestige reached a new level when it won the gold medal for jewelry and grand prize for silverware at the Paris Exposition in 1878 (IDCH). Soon the European royalty was turning to the company for their crown jewels. It's real clientele, however, came from the ranks of America's wealthy.

Charles Tiffany died in 1902, and John C. Moore, great grandson of Tiffany's silversmith, became president. Under Moore's leadership, sales volume rose from \$7 million in 1914 to \$17.7 million in 1919. However, growth was thwarted by the 1929 stock market crash. The economic conditions of the time had severe effects on Tiffany's performance, and sales steadily declined throughout the Great Depression. However, the company never failed to pay a dividend, but had to reach deep into it's capital reserve to do so. Because of the dire times, Tiffany's was forced to close the London branch's doors. The Great Depression took a hard hit on Tiffany's, but the company managed to weather the

subsequent times relatively successfully. In 1940, Tiffany's moved uptown for the final time to its Fifth Avenue and 57th street location, where its Flagship store currently resides. The impressive art deco building was the first completely air conditioned building in New York.

During World War I, they converted their factory production to the manufacture of medical equipment and in World War II, the factory was given over completely to military production, crafting precision parts for anti-aircraft guns. During the Korean War, the company was again flexible and able to move with the times and switched production to military equipment. Tiffany's was somewhat able to bounce back after these hard times, but eventually found itself in a rut as growth became stagnant. An upset board and shareholders appointed a new chairman and CEO, Walter Hoving, who began to turn things around for the company. Hoving's philosophy can be explained in essence by his quote that, "aesthetics, if properly understood, will almost always increase sales." He recruited a "galaxy of stars" to create a new standard of quality for Tiffany's products (IDCH). During this revival, the jewelry workshop's staff grew from eight members to sixty and new designers, including Paloma Picasso, were hired to create jewelry exclusively for Tiffany's. Gene Moore, enlisted with the task of dressing the store's windows, set out to create the striking displays Tiffany's is still known for today. The balance sheet reflected this marketing overhaul. Another strategic component of Hoving's plan was broadening Tiffany's customer base by introducing low price point items such as key chains, which drew in a

much larger clientele. By the early 1960s, a third of the Tiffany's customers, reached through catalogues, lived more than 100 miles away. Stores were opened in Houston, San Francisco, Atlanta, Beverly Hills, and Chicago. Tiffany's Blue Book, initially published in 1845, was the first mail-order catalogue in the U.S. Business continued to grow in the 1970s. Sales rose to all time highs. In 1978, Tiffany and Co. was sold to Avon Products, Inc., the world's leading manufacturer and distributor of cosmetics and costume jewelry, for about \$104 million in common stock. Holving remained chairman and chief executive officer until the end of 1980s, when he retired. When Avon took over, the company faced a sort of identity crisis. The company tried to compete with department stores in selling low-margin watches, china, and glassware. A 1904 *Newsweek* article noted that, "the Fifth Avenue store had stocked so many inexpensive items that it began looking like Macy's during a white sale, and that customers had complained about declining quality and service (IDCH). In 1984, Avon agreed to sell Tiffany to an investor group led by chairman, William R. Chaney. Under its new management, Tiffany & Co. shifted direction again. In 1987, the company went public. Prospects continued looking better and better. A London store was reintroduced, as well as stores in Munich and Zurich. Tiffany's emphasis on luxury drew in the masses; over 25,000 people visited the store on one particular Saturday during the holiday season. Their catalogue mailings continued to be a powerful sales and image tool. The Far East played an important role in Tiffany's revival. Times continued to be successful until, again, they weren't. Due to the 1990-1991

recession in the US, Tiffany began an emphasis on mass merchandising. In similar fashion as to what had been done in the past, the company rebranded and marketed itself as being available to anyone. The company stressed how Tiffany could be affordable for all, advertising diamond rings starting at \$850. In 2000, the Tiffany and Company Foundation was established to provide grants to environmental and artistic nonprofit organizations.

Operations

Head quartered in Tiffany & Co., which is headquarters core business is the retail sale of jewelry, which represented 92% of worldwide net sales in 2013. Tiffany's also sells timepieces, leather goods, sterling silver, china, crystal, stationary, fragrances, and accessories; however sales in these categories represent only seven percent of worldwide net sales. The remaining two percent of worldwide net sales are attributable to wholesale sales of diamonds and earnings received from third-part licensing agreements. Tiffany's is also engaged in the product design and manufacturing processes. The company produces jewelry in New York, Rhode Island, and Kentucky. In total, these manufacturing facilities produce approximately 60 percent of merchandise sold by the Company. The remaining 40 percent is purchased from third-party suppliers. The company may increase the percentage of internally-manufactured jewelry in the future.

Tiffany's has also established diamond processing operations that purchase, sort, cut, and polish rough diamonds for its use. Such operations are located in

Belgium, Botswana, Mauritius, Namibia, South Africa, and Vietnam.

Approximately 60 to 70 percent (by dollar value) of the polished diamonds used in jewelry is produced from rough diamonds the Company has purchased. The balance of its needs for polished diamonds is purchased from polishers or polished-diamond dealers.

The company conducts business in the Americas, the Asian-Pacific, Japan, and Europe. Specifically, the American segment is comprised of the United States, Canada, Mexico, and Brazil; the Asian-Pacific segment, China, Korea, Hong Kong, Taiwan, Australia, Singapore, Macau, and Malaysia; the European segment, the U.K., Germany, Italy, France, Spain, Switzerland, Austria, Belgium, the Czech Republic, Ireland, and the Netherlands. Distribution is achieved through retail stores, internet and catalogue sales, business-to-business sales, and wholesale distribution.

Value Chain



Board of Directors

Current board members and key skills each possesses:

Michael Kowalski

Chairman of the Board and Chief Executive Officer

Merchandising, management, strategic planning and motivation

Rose Marie Bravo

Chief Executive Officer (Retired) Burberry Limited

Brand management, merchandising, and product development

Dr. Gary Costley

Chairman and Chief Executive Officer (Retired), International Multifoods Corporation

Multi-divisional operations, global management, marketing and manufacturing

Frederic Cumanal

President, Tiffany & Co.

International luxury brand management and development

Lawrence Fish

Chairman and Chief Executive Officer (Retired), Citizens Financial Group, Inc.

Risk analysis, finance, brand management and community banking

Abby Kohnstamm

President, Abby F. Kohnstamm & Associates, Inc.

Brand management, global management, strategic planning and media management

Charles Marquis

Senior Advisor, Investcorp International, Inc

Finance, risk analysis, crisis management and investor relations

Peter May

President and Founding Partner, Trian Fund Management, L.P.

Multi-divisional operations, brand management, investor relations and finance

William Shutzer

Senior Managing Director, Evercore Partners

Finance, investor relations and strategic development

Robert Singer

Former Chief Executive Officer of Barilla Holding SpA and Former Chief

Financial Officer of Gucci Group NV

Accounting, global retail, financial and general management of luxury good brands

Chapter 2: Industry, Geographic, and Strategic Analyses

Stated Business Mission and Strategy

Tiffany's mission is focused on fine jewelry success with social and environmental responsibility. Tiffany's defines its mission statement as follows: "To be the world's most respected and successful designer, manufacturer, and retailer of the finest jewelry." Beyond their official mission statement, the company also places emphasis on its social and environmental responsibility mission as well. Michael Kowalski, CEO, has defined the corporate mission by saying, "Tiffany & Co. is committed to obtaining precious metals and gemstones, and crafting our jewelry in ways that are socially and environmentally responsible." The company's key growth strategies (from their website) include:

- To selectively expand their channels of distribution in important markets around the world without compromising the long-term value of the Tiffany & Co trademark
- To increase sales in existing store by developing new products
- To increase its control over product supply and achieve improved profit margins through direct diamond sourcing and internal jewelry manufacturing
- To enhance customer awareness through marketing and public relations programs, and
- To provide customer service that ensures a superior shopping experience

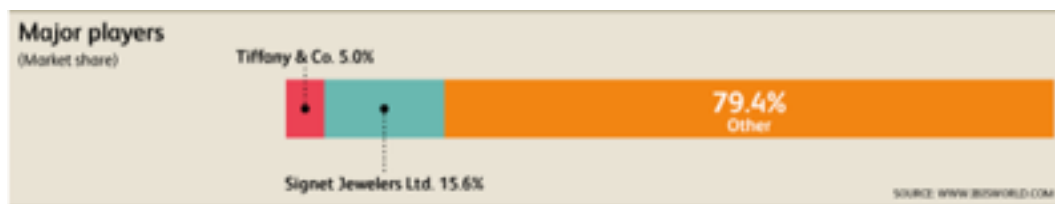
From my own research findings, I believe that Tiffany's primary strategy is maintaining their single most important asset, their brand.

Demand for Products and Services (Outputs) and Supply of Inputs (Labor and Supply Sources)

Tiffany & Co. fits into both the jewelry manufacturing and jewelry retail industries. Supply and demand differs slightly between the two industries. Within the jewelry retail industry, key economic drivers, which in turn have an effect on demand include: per capita disposable income, the number of households earning more than \$100,000, the trade-weighted index, the world price of gold, marriage rates, and the percentage of the population aged 65 and older. Demanders of Tiffany's products are primarily consumers, but also wedding service, college and university, and civic, social, and youth industries. During the recession, Tiffany's experienced weak sales, due to declining demand for such luxurious goods. The demands of Tiffany's retail side primarily drive the demand of the manufacturing side. Within the manufacturing industry, the company's supply is dependent upon copper, nickel, lead and zinc mining, gold and silver ore mining, mineral and phosphate mining, and stone mining. The retail's side supply relies on the company's own manufacturing, as well as outside sourcing. That breakdown, as indicated in Chapter 1, is 60 percent and 40 percent, respectively.

Major Competitors and Performance Relative to Competitors

Because Tiffany & Co. is segmented geographically and because our consumer market today is highly global (foreign brands are widely available), there is much overlap of competitors for the five segments. The two major players in the jewelry retail industry are Signet Jewelers Ltd., which holds a 15.6 percent market share, and Tiffany and Company, which holds only a 5 percent market share. Signet is able to compete on price. Signet Jewelers, which is a UK firm, holds various subsidiaries, including Kay Jewelers, Jared the Galleria of Jewelry, and Zales, among others. Kay Jewelers is a mall-based division of Signet that targets households with incomes ranging between \$35,000 and \$100,000. In that sense, Kay is not really a competitor of Tiffany, as Tiffany targets households with higher incomes. Jared is the company's higher-end retail counterpart and targets households with incomes ranging from \$75,000 to \$150,000. Jared's main strategy, very similar to that of Tiffany, is to provide high-quality customer service, complete with knowledgeable staff and on-site design and repair centers.



Other competitors of Tiffany's include brands, some privately held, such as Harry Winston, Hermes, David Yurman, Swatch Group, Burberry, and Christian Dior. Essentially any other luxury brand could be considered a competitor, in the sense that they are selling a substitute good. Blue Nile, an online-only retailer of

diamonds could be considered another competitor, although their sales are much smaller than Tiffany's. Retail stores, such as Saks and Nordstrom are also competitors. Tiffany's is a segment market leader.

Operations outside of US & associated risks and rewards

Tiffany's does operate outside the U.S. Due to its large international segment, exchange rates play a major role in Tiffany's performance. Due to foreign exchange rate fluctuations, sales abroad can be worth either more or less when translated back into dollars. Tiffany minimizes the potential negative impact of a stronger U.S.dollar against the Japanese yen by purchasing put option contracts as hedges of forecasted purchases of merchandise over a maximum term of 12 months (Wiki Invest). Exchange rates play a part in domestic sales as well, as they influence foreign tourist spending.

Porter's 5 Forces and SWOT Analysis

Bargaining Power of Suppliers:

The bargaining power of suppliers is moderate to high. The diamond suppliers have high bargaining power. The DeBeer's monopoly has a large impact.

Intensity of Existing Rivalry:

Rivalry among existing companies is high. The economy is making an upward

climb, which means higher disposable incomes. Consumers have means to make luxury purchases. This fact attracts major industry players. As well, there are high barriers to exit, due to high start-up fixed investments and contracts with suppliers.

Threat of Substitutes:

There is a moderate to high threat of substitutes. Depending on brand loyalty, which differs depending on the consumer and the availability of substitutes, the threat of substitutes could rise.

Bargaining Power of Customers:

The bargaining power of customers is low. Tiffany's does not have one primary buyer. All buyers buy in small volumes.

Threat of New Competitors:

Threat of new entrants is low, due to high barriers to entry. High capital investment and start up costs exist. As well, there is a limited source of suppliers and distribution channels.

Strengths:

1. Branding and customer loyalty
2. Employees

3. Suppliers with similar values
4. Packaging and Catalogues

Weaknesses:

1. Lack of brand awareness in Asia

Opportunities:

1. Growth in Asia-Pacific
2. Expansion in retail stores

Threats:

1. Counterfeit goods
2. Numerous competitors
3. Changes in prices of diamonds

Chapter 3: Financial Statement Analysis Part I

Asset Composition

Tiffany's assets as of January 31, 2014 include cash and cash equivalents; short-term investments; accounts receivable (less their allowances); inventories; deferred income taxes (both current and non-current); prepaid expenses and other current assets; property, plant, and equipment; and other non current assets.

The cash and cash equivalents are stated at cost plus accrued interest, which approximates fair value. Cash equivalents include highly liquid investments with an original maturity date of three months or less and consist of time deposits and/or money market fund investments with a number of U.S. and non-U.S. financial institutions with high credit rankings. There should be little disparity between the balance sheet value and the true value of the cash and cash equivalents.

The short term investments are classified as available-for-sale and are carried at fair value. At January 31, 2014, the Company's short term available-for-sale investments consisted entirely of time deposits. The balance sheet value of short term investments should be reasonably accurate.

In regards to the receivables, the company maintains an allowance for estimated losses associated with the accounts receivable recorded on the balance sheet. The allowance is determined by a combination of factors, including the length of time the receivables are past due, the Company's knowledge of the customer, economic and market conditions and historical write-off experiences.

Within the accounts receivable are Credit Card Receivables, which arise from purchases made on Tiffany & Co. credit cards. For all Credit Card Receivables recorded on the balance sheet, once all internal collection efforts have been exhausted and management has reviewed the account, the account balance is written off.

According to the company's most recent financial statement, "the TIFFANY & CO. brand (the "Brand") is the single most important asset of Tiffany. The strength of the brand goes beyond trademark rights and is derived from customer perception of the Brand. I believe what they are referring to in this statement encompasses their goodwill.

Trademarks-

The designations "TIFFANY® and TIFFANY & CO.® are the principal trademarks of the company, as well as the TIFFANY BLUE BOX® and the color TIFFANY BLUE®.

Tiffany's asset portion of the balance sheet is as follows:

Current assets

Cash and cash equivalents	\$345,778
Short-term investments	21,257
Accounts receivable (less allowance of \$10,337)	188,814
Inventories, net	2,326,580
Deferred income taxes	101,012
Prepaid expenses and other current assets	244,947
Total current assets	3,228,388
Property, plant, and equipment, net	855,095
Deferred income taxes	278,390
Other assets, net	390,478
Total assets	4,752,351

The fact that, because estimates are used, "actual results could differ from estimates and the differences could be material," is stated in the footnotes.

One of the key success factors for companies in the jewelry stores industry is the ability to control stock on hand. Due to the high cost and low volume of stock on hand, successful operators must ensure that they are not overstocked or understocked.

Financing

The company is financed pretty evenly by both debt and equity, which has stayed rather consistent over the last five years. Tiffany & Co. has no off balance sheet financing.

Statement of Cash Flows

The net cash provided by operating activities is positive for each year. The net cash flows used by investing activities is negative for each year. The net cash flow of financing activities is negative in 2014, 2012, and 2011, and positive in 2013 and 2010. Tiffany & Co does not fit neatly into either the introductory, growth, maturity, or decline phases as defined by the cash flow life cycle diagram. A positive cash flow from operating activities is a sign of health for a firm, and highlights their ability to make a profit. Generating positive, sustainable cash flow is critical for a firm's long-term success. Negative numbers shown in financing activities can mean the company is servicing debt but also could mean that they are making dividend payments and stock repurchases, which investors might be happy to see. From a corporate perspective, investing cash flow activities are generally referring to money made or spent on long-term assets the company has purchased or sold.

Liquidity and Solvency

Liquidity ratios:

Current Ratio

14	13	12	11	10
<u>\$ 3,228,388</u>	<u>\$ 3,151,589</u>	<u>\$ 2,889,675</u>	<u>\$ 2,684,545</u>	<u>\$ 2,445,666</u>
\$ 696,740	\$ 586,592	\$ 626,677	\$ 479,913	\$ 600,273
=	=	=	=	=
4.63	5.37	4.61	5.59	4.07

The higher the current ratio, the more capable a company is of paying its obligations. In theory, the higher the current ratio, the better. However, the current ratio does have flaws. In reality, complete liquidation is highly unlikely. Entities should be viewed as a going concern. The amount of time a company takes to turn its current assets into cash to pay its current obligations is key.

Working capital (in thousands)

14	13	12	11	10
\$2,531,648	\$2,564,997	\$2,262,998	\$2,204,632	\$1,845,393

Solvency ratios:**Debt to Equity**

14	13	12	11	10
$\frac{\$ 2,018,383}{\$ 2,733,968}$	$\frac{\$ 2,019,532}{\$ 2,611,318}$	$\frac{\$ 1,810,087}{\$ 2,348,905}$	$\frac{\$ 1,558,194}{\$ 2,177,475}$	$\frac{\$ 1,605,121}{\$ 1,883,239}$
=	=	=	=	=
.74	.77	.77	.72	.85

A higher debt/equity ratio can be interpreted to mean that a company has been aggressive in financing its growth with debt.

Times Interest Earned

14	13	12	11	10
$\frac{\$ 317,520}{\$ 62,654}$	$\frac{\$ 702,645}{\$ 59,069}$	$\frac{\$ 713,525}{\$ 48,574}$	$\frac{\$ 601,769}{\$ 54,335}$	$\frac{\$ 444,162}{\$ 55,041}$
=	=	=	=	=
5.07	11.90	14.69	11.08	8.07

Earnings Per Share and Related Trends

14	13	12	11	10
$\frac{\$ 181,369 - 0}{127,835}$	$\frac{\$ 416,157 - 0}{126,737}$	$\frac{\$ 439,190 - 0}{127,397}$	$\frac{\$ 368,403 - 0}{126,600}$	$\frac{\$ 264,823 - 0}{124,345}$
=	=	=	=	=
\$ 1.42	\$ 3.28	\$ 3.45	\$ 2.91	\$ 2.13

Weighted average shares outstanding has not differed too significantly from

year to year over the past five years and the company has no issued and outstanding preferred stock. Therefore, the changes in EPS is attributable mainly to the differing net incomes. Net income steadily increased from 2010 to 2012, as did EPS. In 2013, a decrease in net income resulted in a lower EPS. The same was true for 2014. The significant decrease in net income in year 2014 is due not to low sales, but to a \$480 billion arbitration expense occurred in that period.

Chapter 4: Financial Statement Analysis Part II

Receivables

The receivables that appear on the balance sheet are primarily Credit Card Receivables that arise from customer purchases made with their Tiffany & Co. credit cards. I would think that the company would have other receivables, such as interest receivable from investments they hold, etc.; however, no such receivables are mentioned in the financial statements.

Customers and Their Credit Worthiness

The company's customers are mostly individuals. There are some corporations who purchase from Tiffany's for company needs. For example the US Open commissions Tiffany's to produce their trophies. Tiffany's uses various indicators to determine whether to extend credit to customers and the amount of credit. Such indicators include reviewing prior experience with the customer, including sales and collection history, and using applicants' credit reports and other scores provided by credit rating agencies.

Changes in Accounts Receivable Turnover and Average Collection Period

Accounts Receivable Turnover

2013	2012	2011	2010	2009
15	21	20	18	17

*Net credit sales were not available, so net sales were used for calculation

*Average accounts receivable is average of current year and previous year

Average Collection Period

2013	2012	2011	2010	2009
17.1	16.7	18.4	22	21.4

A higher accounts receivable turnover ratio is indicative of a company that is collecting their receivables more frequently throughout the year. If the accounts receivable collection period value is increasing, it means that customer payments are slowing, which could lead to reduced sales in the future. In Tiffany's case, the accounts receivable turnover ratio steadily increases from 2009-2012, but drops to a five year period low in 2013. The average collection period is rather inconsistent: it increases from 2009 to 2010, decreases in 2011 and again in 2012, and then goes up slightly in 2013.

Bad Debt

As discussed in chapter 3, the allowance is determined by a combination of factors, including the length of time the receivables are past due, the Company's knowledge of the customer, economic and market conditions and historical write-off experiences. It's essential to analyze Bad Debt Expense and the Allowance for Uncollectible Accounts each year in order to ensure that those estimates are actually accurate.

Accounts Receivable as Possible Means to Manipulate Net Income

A company could possibly report an unrealistically high bad debt expense, which would in turn reduce taxable income, potentially saving the company a significant amount of money.

Inventories

The company maintains Finished goods, Raw materials, and Work-in-process inventories. Inventories are valued at the lower of cost or market using the average cost method except for certain diamond and gemstone jewelry which uses the specific identification method.

Gross Profit Margin Changes

2013	2012	2011	2010	2009
0.58	0.57	0.59	0.59	0.56

The Gross Profit Margin has remained relatively consistent over the past five years. The one point increase from 2012 to 2013 occurred primarily because of reduced product cost pressures and price increases taken in the first half of the year. A continued shift in sales-mix toward higher-priced, lower-margin products offset a portion of these benefits.

Gross margin decreased by 2 points in 2012, largely due to high precious metal and diamond costs, as well as a shift in sales mix toward high-priced, lower-margin products, and reduced sales leverage on fixed costs. Sales mix was affected by, among other items, a decline in sales of silver jewelry, which earns a higher margin than the Company's overall gross margin.

Changes in Inventory Turnover and Average Inventory Days Outstanding Ratios

Inventory Turnover

2013	2012	2011	2010	2009
0.74	0.76	0.81	0.83	0.83

Inventory Days Outstanding

2013	2012	2011	2010	2009
495	493	500	463	436

Tiffany's turned over inventory .74 times during 2013. This low inventory turnover ratio may mean that the company has much more inventory than it really needs at any one time. Therefore it has too much of its capital tied up in goods or raw materials that it will take a long time to sell or make a profit on. However, a company with high profit margins can worry less about a low turnover ratio (Small Business Chronicle).

The Inventory Days Outstanding figure determines the number of days it will take a company to sell all of its inventory. Tiffany's inventory days outstanding is very high, which may be an indicator that they are not very liquid.

Inventories at Possible Means to Manipulate Net Income

As I recall from intermediate, the choice of cost flow assumptions has an effect on COGS. Assuming prices are rising, a LIFO cost flow assumption will result in a higher COGS and consequently a lower taxable net income.

Additionally, companies could delay write downs in order to avoid recognizing losses.

Property, Plant, and Equipment

Depreciation Method

Depreciation is calculated on a straight-line basis over the following estimated useful lives:

Buildings	39 years
Machinery and Equipment	5-15 years
Office Equipment	3-8 years
Furniture and Fixtures	2-10 years

Leasehold improvements and building improvements are amortized over the shorter of their estimated useful lives or the related lease terms or building life, respectively. Maintenance and repair costs are charged to earnings, while expenditures for major renewals and improvements are capitalized.

Additions to PP&E

The company has not added any PPE over the past year.

Impairments

The company reviews its long-lived assets other than goodwill for impairment when management determines that the carrying value of such assets may not be recoverable due to events or changes in circumstances. The company

recorded no material impairment charges in 2013, 2012, or 2011.

PP&E Analysis

Fixed asset turnover ratio:

Revenue / PPE

$$4,031,130 / 855,095 = 4.7$$

The higher the turnover ratio, the better. The fixed asset turnover ratio reflects whether a company is efficiently managing their fixed assets.

Approximate age estimate:

Accumulated depreciation / Annual depreciation expense

$$1,243,547,000 / 171,452,000 = 7.25 \text{ years}$$

Comparing the approximate age from year to year is useful in determining whether company is growing their asset base or letting it deteriorate.

Remaining service life of PPE:

Historical cost / Annual depreciation expense

$$2,098,642,000 / 171,452,000 = 12.2 \text{ years}$$

Useful in planning for when new fixed assets will need to be purchased in the future.

PP&E As Possible Means to Manipulate Net Income

A company could temporarily boost earnings by delaying investment in PPE.

The depreciation expense would be lower, as an older asset would be recorded at

historical cost, which would be much less than the cost to purchase today.

Additionally, a company's depreciation method can significantly influence net income. A company using double declining depreciation would experience higher incomes in assets' later lives.

Chapter 5: Financial Statement Analysis Part III

Intercorporate Investments and Goodwill

In July 2012, the Company, through a venture with its former independent distributor, Damas Jewellery LLC ("Damas"), acquired the net assets associated with five existing independently-operated Tiffany & Co. stores located in the U.A.E. for \$25,000,000, of which \$24,493,000 was allocated to goodwill and the remainder to other tangible assets and liabilities. The purchase resulted in the recognition of goodwill because the acquisition enabled the Company to immediately integrate five existing Tiffany & Co. stores into its worldwide store network and will enhance awareness of the Company's brand in the U.A.E.

In accordance with the agreement, the Company owns 49 percent of the common shares of the venture with Damas and will be entitled to 75 percent of the profits or losses of the venture. The Company is responsible for all merchandise assortment and pricing, advertising and promotional activities, staffing, store design and visual display and financial services. The Company has evaluated the variable interest entity consolidation requirements with respect to this transaction and has determined that the Company is the primary beneficiary as it has both the power to direct the activities that most significantly affect the venture's economic performance as well as the obligation to absorb losses of and the right to receive benefits that are significant to the venture. Therefore, the

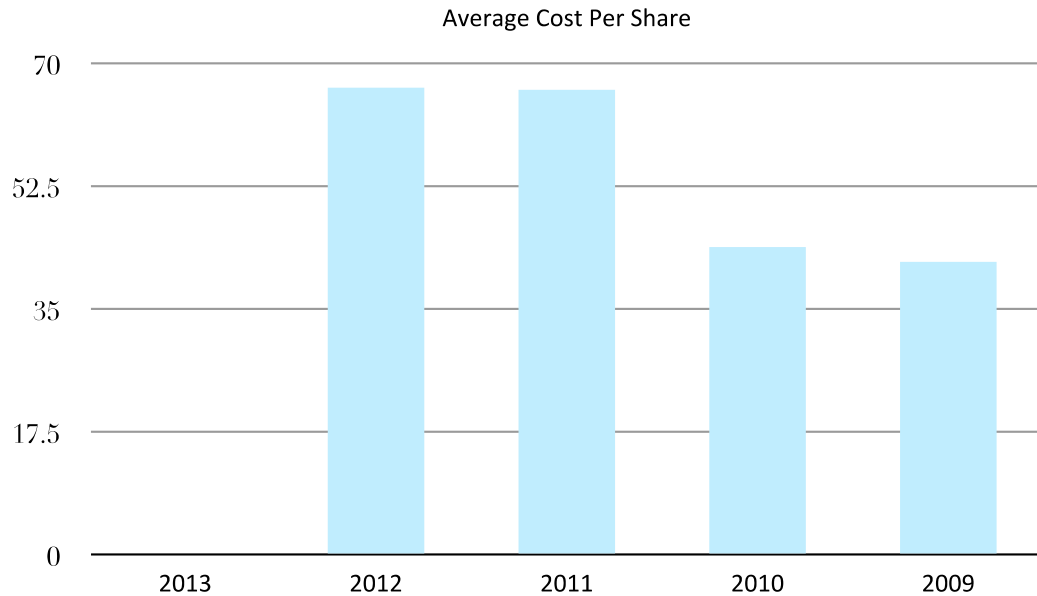
results of the venture are consolidated within the financial results of the Company. Income or loss attributable to the non-controlling interests is presented within other income, net as the amount is not material. The results of the venture and the associated goodwill are included within the Other non-reportable segment.

Restructuring Charges.

There have been no restructuring charges over the past five years.

Foreign Currency Changes

Foreign currency rates are of particular importance to a retailer such as Tiffany & Co. The U.S. domiciled company has operations and makes sales overseas, so must translate sales from abroad (in euros, etc.) back to U.S. dollars. Also, a proportion of Tiffany U.S. sales come from visiting tourists. Unfavorable rates for foreign tourists discourage their spending while abroad. Foreign currency changes have had a significant impact on profitability recently for Tiffany & Co in the future. Due to slowing economies in Europe, China, and Japan, the dollar has spurred to its highest level in more than a decade against the world's major currencies. The stronger dollar is predicted to result in significant headwinds for the company in 2015 that will hurt sales to tourists in the U.S. as well as current translations from sales abroad.



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Share Repurchases, Stock Dividends, and Stock Splits

There have been share repurchases over the past five years. There were no repurchases in 2013, however there were repurchases of 813,000 shares for \$54,107,000 in 2012, 2,629,000 shares for \$174,118,000 in 2011, 1,843,000

shares for \$80,786,000 in 2010,
and 11,000 repurchases for \$467,000 in 2009.

The cash dividend on the Company's Common Stock was increased once in each of 2013, 2012 and 2011. The Company's Board of Directors declared quarterly dividends which totaled \$1.34, \$1.25 and \$1.12 per common share in 2013, 2012 and 2011 with cash dividends paid of \$170,312,000, \$158,594,000 and \$142,840,000 in those respective years. The dividend payout ratio (dividends as a percentage of net earnings) was 94 percent, 38 percent and 33 percent in 2013, 2012 and 2011. Dividends as a percentage of adjusted net earnings were 35 percent in 2013 and 31 percent in 2011.

There have been no stock splits in the past 5 years.

Pensions

The Company maintains several pension plans as part of their employee benefits program. The company makes certain assumptions that affect the underlying estimates related to pension and other post-retirement costs. Significant changes in interest rates, the market value of securities and projected health-care costs would require the Company to revise key assumptions and could result in a higher or lower charge to earnings.

The Company used discount rates of 4.50 percent to determine its 2013 pension expense for all U.S. plans and 4.50 percent to determine its 2013 postretirement expense. Holding all other assumptions constant, a 0.5 percent

increase in the discount rate would have decreased 2013 pension and postretirement expenses by \$5,678,000 and \$527,000. A decrease of 0.5 percent in the discount rate would have increased the 2013 pension and postretirement expenses by \$6,307,000 and \$770,000. The discount rate is subject to change each year, consistent with changes in the yield on applicable high-quality, long-term corporate bonds. Management selects a discount rate at which pension and postretirement benefits could be effectively settled based on (i) an analysis of expected benefit payments attributable to current employment service and (ii) appropriate yields related to such cash flows.

The Company used an expected long-term rate of return of 7.50 percent to determine its 2013 pension expense. Holding all other assumptions constant, a 0.5 percent change in the long-term rate of return would have changed the 2013 pension expense by \$1,483,000. The expected long-term rate of return on pension plan assets is selected by taking into account the average rate of return expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation. More specifically, consideration is given to the expected rates of return (including reinvestment asset return rates) based upon the plan's current asset mix, investment strategy and the historical performance of plan assets.

For postretirement benefit measurement purposes, 7.00 percent (for pre-age 65 retirees) and 6.25 percent (for post-age 65 retirees) annual rates of increase in the per capita cost of covered health care were assumed for 2014. The rates were

assumed to decrease gradually to 4.75 percent by 2020 and remain at that level thereafter. A one-percentage-point change in the assumed health-care cost trend rate would not have a significant effect on the aggregate service and interest cost components of the 2013 postretirement expense.

Chapter 6: Financial Statement Analysis Part IV

Classification of each item on the income statement and balance sheet (operating versus non-operating).

Operating items indicated in red

BALANCE SHEET

ASSETS

Current assets:

Cash and cash equivalents

Short-term investments

Accounts receivable, less allowances

Inventories, net

Deferred income taxes

Prepaid expenses and other current assets

Property, plant and equipment, net

Deferred income taxes

Other assets, net

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

Short-term borrowings

Accounts payable and accrued liabilities

Income taxes payable

Merchandise and other customer credits

Long-term debt

Pension/postretirement benefit obligations

Deferred gains on sale-leasebacks

Other long-term liabilities

Commitments and contingencies

Stockholders' equity: Preferred Stock

Common Stock

Additional paid-in-capital

Retained earnings

Accumulated other comprehensive loss, net of tax

Total Tiffany & Co. stockholders' equity

Non-controlling interests

Total stockholders' equity

INCOME STATEMENT

Net sales

Cost of sales

Selling, general and administrative expenses

Interest expense and financing costs

Other income, net

Provision for income taxes

*An arbitration expense of \$480,211,000 exists in the financial statements for the year ended January 31, 2014. This arbitration expense is not expected to occur in the future. For my calculations, I will ignore this arbitration expense.

Financial statement analysis:

- Statutory state and federal tax rate for each of the five following years.

The statutory federal and state tax rates were given in the financials. They are as follows:

	2013	2012	2011	2010	2009
Federal	35%	35%	35%	35%	35%
State	3%	3.3%	2.8%	2.4%	3.7%
Total	38%	38.8%	37.8%	37.4%	38.7%

Additionally, the effective rates for each year were given in the financials. They

are as follows:	2014	2013	2012	2011	2010
Effective	35%	28.8%	35.3%	34.0%	32.7%

- NOPAT

NOPAT = Net operating profit before tax (NOPBT) - Tax on operating profit

Tax on operating profit = Tax expense + (Pretax net nonoperating expense x Statutory tax rate)

	2013	2012	2011	2010	2009
NOPBT	784,540	697,217	708,426	594,781	440,492

	2013	2012	2011	2010	2009
NOPAT	687234.48	447174.57	464304.03	395428.71	294893.13

- NOA

NOA = Operating Assets - Operating Liabilities

2013	2012	2011	2010	2009
\$3,452,317	\$3,161,113	\$2,738,554	\$2,249,824	\$1,980,235

(in thousands)

- RNOA

RNOA = $\frac{\text{Net operating profit after tax (NOPAT)}}{\text{Average net operating assets (NOA)}}$

2013	2012	2011	2010	2009
.21	.15	.19	.19	.15

- ROE

Return on Equity = Net Income / Average Stockholders' Equity

2014	2013	2012	2011	2010
.19	.17	.19	.18	.15

- Non-Operating Return

2013	2012	2011	2010	2009
.19	.17	.19	.18	.14

RNOA Disaggregation:

- NOPM

2013	2012	2011	2010	2009
.17	.12	.13	.13	.11

- NOAT

2013	2012	2011	2010	2009
1.17	1.20	1.33	1.37	1.37

- NOPM and NOAT Components

Breaking down NOPM,

GPM

2013	2012	2011	2010	2009
.58	.57	.59	.59	.56

OEM

2013	2012	2011	2010	2009
.81	.82	.81	.81	.84

Breaking down NOAT,

ART

2013	2012	2011	2010	2009
21.06	19.99	18.51	16.71	16.77

INVT

2013	2012	2011	2010	2009
.74	.76	.81	.83	.78

LTOAT

2013	2012	2011	2010	2009
2.68	2.76	3.14	2.95	2.59

APT

2013	2012	2011	2010	2009
5.30	5.22	5.08	5.15	5.18

NOWCT

2013	2012	2011	2010	2009
9.23	8.00	6.16	4.04	6.90

Non-Operating Return Decomposed into FLEV and Spread

FLEV

2013	2012	2011	2010	2009
.24	.19	.10	.04	.06

Spread

2013	2012	2011	2010	2009
(.05)	.09	.08	(.13)	(.16)

Ratio Limitations

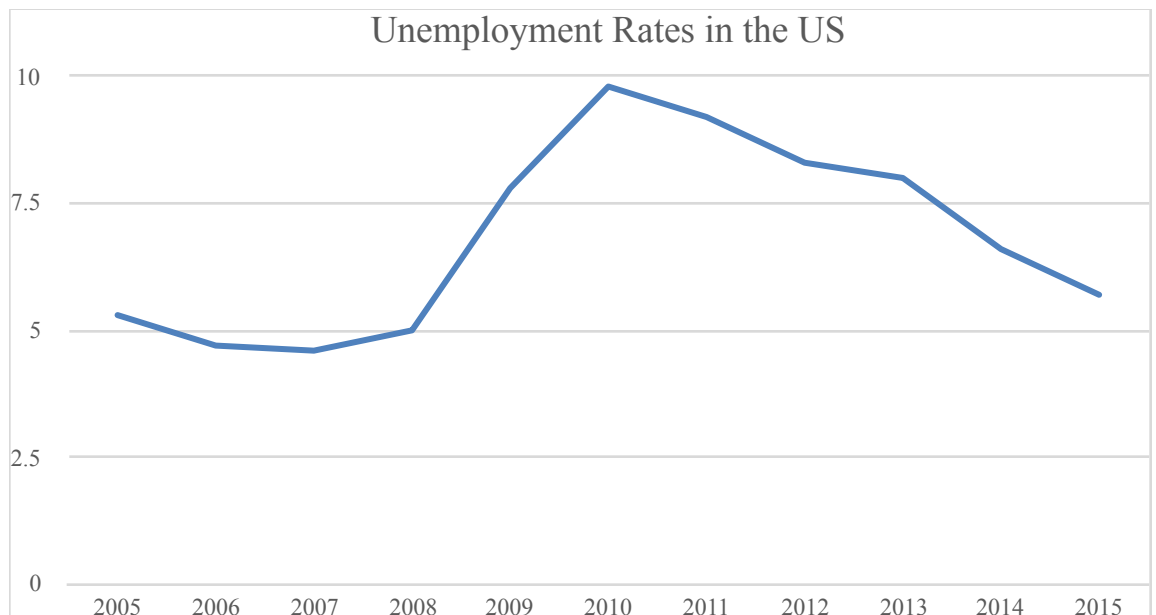
One disadvantage of ratio analysis is the fact that ratios do not take into account certain unrecognizable assets, for example ones generated internally like brand name, superior management, employee skills, and a reliable supply chain. This limitation is particularly true of ratios computed for Tiffany & Co., as one of Tiffany's main assets is its brand. Another limitation of ratios is the exclusion of non-capitalized costs. Finally, a third limitation of ratios is the fact that most assets and liabilities are recorded at historical costs, which are not nearly as relevant.

Chapter 7: Accounting Quality

Macroeconomic Indicators

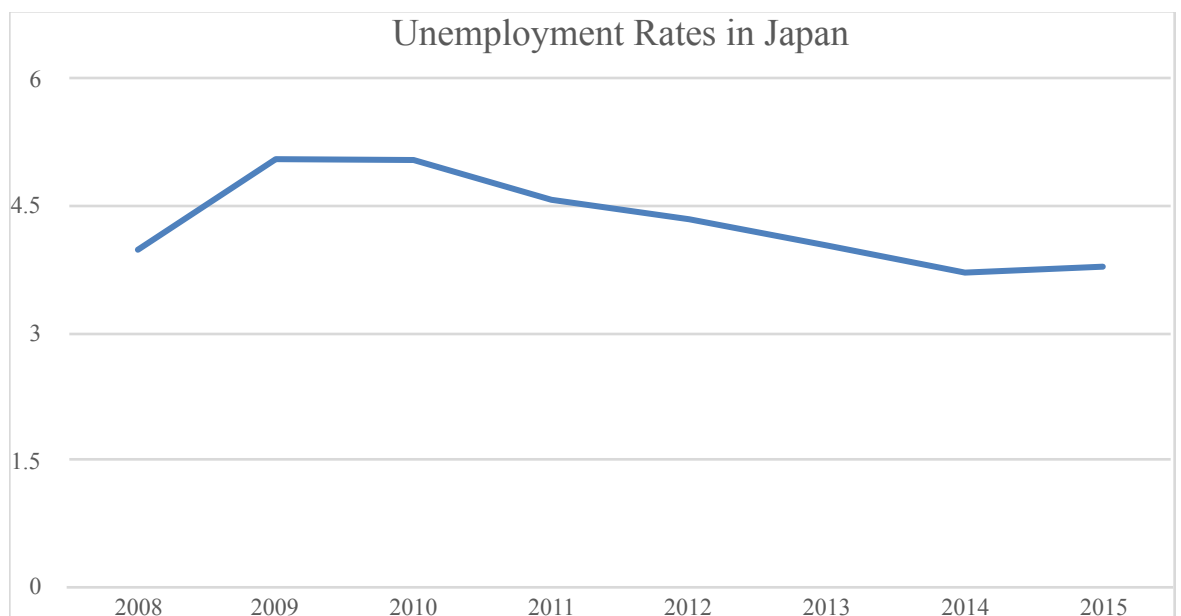
As a retailer of goods which are discretionary purchases, Tiffany & Co.'s sales results are particularly sensitive to changes in economic conditions and consumer confidence. Consumer confidence is affected by inflation; interest rates and the availability of consumer credit; and expectations of future economic conditions and employment prospects.

Unemployment rates measure the number of people looking for work as a percentage of the total labor force. The following graph depicts US unemployment rates over the past 10 years. In a healthy economy, the unemployment rate will range from 3 to 5 percent.



(BLS.gov)

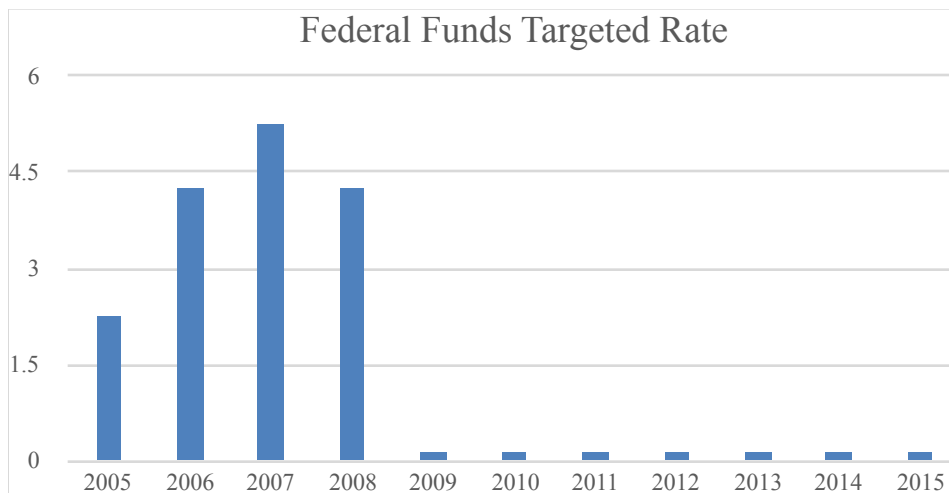
As evidenced in the graph, unemployment rates have been experiencing levels of distress since around 2008. High unemployment means less disposable income for consumers, which therefore has major implications for a luxury retailer like Tiffany's. Unemployment rates for Tiffany's second major business segment, Japan, are also presented below.



(Statista)

Unemployment rates are much more stable in Japan, so the issue of unemployment is not as relevant to this segment as it is to the US segment.

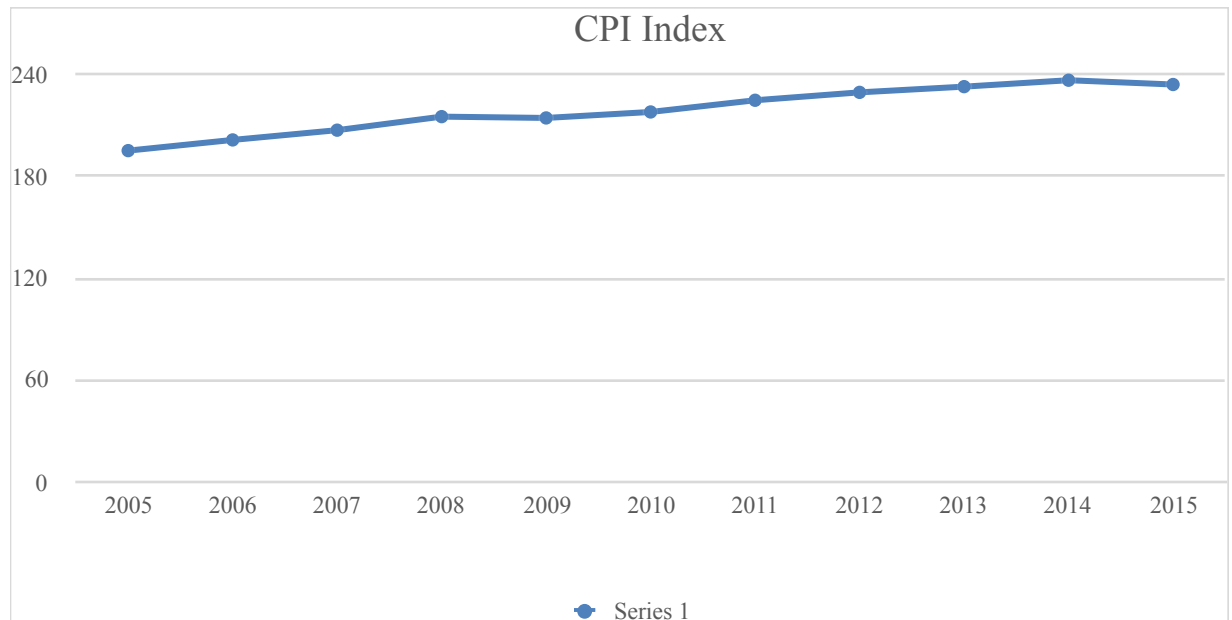
Another macroeconomic factor that has an effect on Tiffany's operations is the interest rate. If interest rates are not favorable, consumers will be discouraged from taking out debt. The following graph is of the Federal Funds targeted interest rates. Interest rates have been very low in recent years, which makes it cheaper for consumers to borrow money from banks.



(Money Cafe)

A third macroeconomic factor that Tiffany & Co. is inflation and the CPI. CPI reflects the increased cost of living, or inflation. The CPI is calculated by measuring the costs of essential goods and services, including vehicles, medical care, professional services, shelter, clothing, transportation and electronics. Inflation is then determined by the average increased cost of the total basket of goods over a period of time. Why might changes in CPI be relevant to Tiffany and Co.? If the price of living is increasing, consumers might think twice before

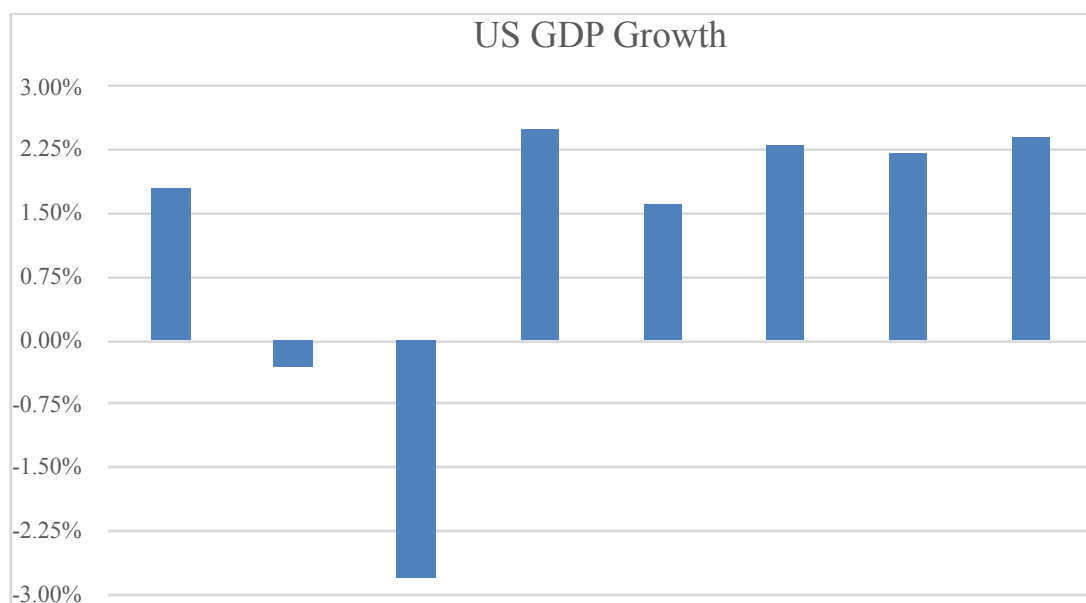
buying diamond jewelry. The following graph depicts changes in CPI over the past 10 years.



(Inflation Data)

Another macroeconomic factor that has implications for Tiffany & Co. is currency strength, which is explained in more depth in Chapter 5. Currency strength affects purchasing power, as well as translation of profits from overseas back into US dollars.

Finally, a fifth macroeconomic factor that affects Tiffany & Co. is changes in Gross Domestic Product (GDP). When GDP increases, it's an indicator that the economy is strong. Tiffany & Co. will adjust its expenditures on inventory, payroll, and other investments based on GDP output.



2007 2008 2009 2010 2011 2012 2013 2014

Appropriateness of the Revenue Recognition Policies

In order to determine if revenue recognition policies are appropriate, it is helpful to compute and evaluate the following indexes.

Sales Growth Index (SGI) = Current Sales / Prior Year Sales

For 2013, 4,031,130,000 / 3,794,249,000 = **1.06**

For 2012, 3,794,249,000 / 3,642,937,000 = **1.04**

For 2011, 3,642,937,000 / 3,085,290,000 = **1.18**

For 2010, 3,085,290,000 / 2,709,704,000 = **1.13**

For 2009, $2,709,704,000 / 2,848,859,000 = \mathbf{0.95}$

Except for from 2008-2009, sales have increased every year. The increases in sales from year to year are most likely accurate, however, there is the possibility that the appearance of the increases in sales in the financial statements are rather the results of revenue and expense manipulation.

Gross Margin Index (GMI) = Current Gross Margin / Prior Year Gross Margin

For 2013, $.581 / .570 = \mathbf{1.019}$

For 2012, $.570 / .591 = \mathbf{0.964}$

For 2011, $.591 / .591 = \mathbf{1.000}$

For 2010, $.591 / .565 = \mathbf{1.770}$

For 2009, $.565 / .564 = \mathbf{1.002}$

Except for in 2012, the company's GMI is greater than 1, which means that the company's gross margins have deteriorated. Therefore, management might be motivated to show better earnings.

Sales, General and Administrative Expense Index (SGAI) = [(Current SGA Expense / Current Sales) / (Prior Year SGA Expense / Prior Year Sales)]

For 2013, $(1,555,903 / 4,031,130) / (1,466,067 / 3,794,249) = .3859 / .3864 = \mathbf{0.9987}$

For 2012, $(1,466,067 / 3,794,249) / (1,442,728 / 3,642,937) = .3864 / .3960 =$
0.9758

For 2011, $(1,442,728 / 3,642,937) / (1,227,497 / 3,085,290) = .3960 / .3979 =$
0.9952

For 2010, $(1,227,497 / 3,085,290) / (1,172,592 / 2,859,997) = .3979 / .4010 =$
0.9923

For 2009, $(1,172,592 / 2,859,997) / (1,204,990 / 2,938,771) = .4010 / .4100 =$
0.9780

The SGAI is close to 1 for all years. However, because it's slightly less than 1, sales are increasing faster than expenses. There needs to be an explanation for why that is the case. Otherwise, SGAI could be pointing to overstated revenues.

All three indexes reveal that there is reason to suspect that revenue might not be being recognized properly.

According to the revenue recognition policies in the company's 10-K, "Sales are recognized at the 'point of sale,' which occurs when merchandise is taken in an 'over-the-counter' transaction or upon receipt by a customer in a shipped transaction, such as through the Internet and catalog channels. Revenue associated with gift cards and merchandise credits is recognized upon redemption. Sales are reported net of returns, sales tax and other similar taxes. Shipping and handling fees billed to customers are included in net sales. The Company maintains a reserve for potential product returns and it records, as a reduction to

sales and cost of sales, its provision for estimated product returns, which is determined based on historical experience.”

This statement does not reveal much into the revenue recognition policies of the company. Therefore, it is difficult to assess the appropriateness of their policies with this limited information. Some ways retailers in general could potentially misreport revenue might include:

1. Chanel Stuffing
2. Reporting revenues at gross rather than net (The Financials do indicate that shipping and handling fees billed to customers are included in net sales, although that does not seem like it would significantly and/or materially alter revenue amounts).
3. Barter transactions
4. Bill and hold transactions

I did not find any evidence of such occurrences in the information that I have available to me. However, such instances could be occurring, but I would need to have greater access to company proceedings (like the access an auditor would have) to be able to determine if revenue is, in fact, being reported incorrectly.

Earnings Targets

The earnings estimate for 2014, based on 28 analyst estimates, was a high of \$3.86, a low of \$3.70, and a consensus of \$3.77. Actual earnings were \$3.73,

which was a negative surprise of -1.01 percent. The earnings estimate for 2013, based on 22 analyst estimates, was a high of \$3.31, a low of \$3.20, and a consensus of \$3.21. Actual (diluted) earnings were \$3.25, which was a positive surprise of +1.20 percent. This information comes from Bloomberg.com and the actual earnings that they report for 2013 of \$3.25 is inconsistent with the EPS reported in the financial statements of \$1.41 (diluted). The 2012 analyst estimate for Tiffany's earnings was \$3.98 per share and the actual diluted EPS was \$3.25, so they failed to meet expectations that year.

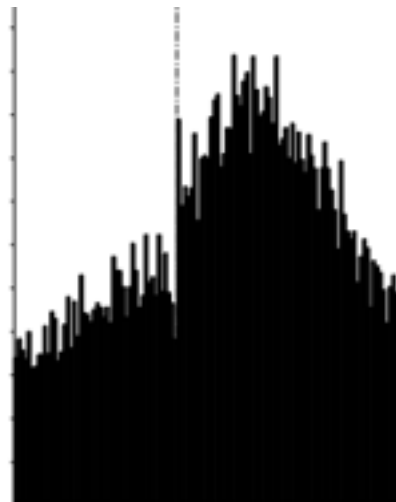
I searched Yahoo Finance, Mergent Online, as well as used the Google search engine to try to find more accurate projects, as well as projections for years 2011-2009; however, I was not able to find such information. From the information I was able to find, it looks like they failed to meet expectations the past three years. (Bloomberg)

Reasons for Earnings Management (Both Upward and Downward)

One of the most prevalent reasons Tiffany & Co. management might feel pressure to manage earnings upward is to meet or beat Wall Street expectations, so that the market price of their stock and the value of management's stock options increase. There are various ways management could potentially make earnings appear to be greater than they actually are. One way which management could make earnings look higher is in a loss carryforward situation. The use of a valuation allowance provides a company with an opportunity to manage its

earnings. As one accounting expert notes, “The ‘more likely than not’ provision is perhaps the most judgmental clause in accounting.” Some companies may set up a valuation account and then use it to increase income as needed (Keiso, Weygandt, and Warfield page 1137). Another simple way a retailer like Tiffany and Co. could manage earnings upward is to make overly optimistic estimates of their allowance for doubtfuls, thereby reducing current expenses.

Conversely, the company might want to manage earnings downward. Take for example the year of 2013 for Tiffany and Co, during which they faced a \$480,211,000 arbitration expense, which had detrimental effects on their net income for that year; net income for 2013 was \$181,369,000, as compared to \$484,179,000 in 2014 and \$416,157,000 in 2012. Perhaps their mentality is: “since we’re obviously going to miss analyst expectations for the year anyway, we might as well go ahead and take a hard hit now.” This phenomena is very common and is explained by the following graph.



In this graph, there is a discontinuity around zero, demonstrating the point that when companies miss expectations, they miss them by a lot. Tiffany & Co could go ahead and incur imminent expenses now, as opposed to having to recognize them next period, making it easier to achieve profits in 2014. Tiffany could do so several ways. Since inventories (a large component of a retailer like Tiffany's assets) must be stated at the lower of cost or market, managers could go ahead and write them down in this period, which would result in a greater profit margin next period when they are sold. Additionally, the company could establish "cookie jar" reserves. They could establish these reserves by using unrealistic assumptions to estimate liabilities for such items as loan losses, restructuring charges, and warranty returns. The company could then reduce these reserves in the future to increase reported income in the future.

Chapter 8: Equity Valuation

Conversion of Operating Leases to Capital Leases for Stock Valuation Purposes

Leases are important to a retailer like Tiffany & Co., as they must secure store facilities. While Tiffany & Co. does own some of its properties, it also rents a significant portion of them as well. Tiffany & Co. maintains operating leases on their rentals. For the purposes of analysis, I will capitalize the operating leases to show what differences would arise if the leases were to be capital rather than operating leases. The first step for capitalizing the leases is to determine the discount rate. The discount rate could be imputed from the approximated future capital lease payments in the lease footnote. However, from looking at Tiffany's 10-K, it appears that they have no capital leases. Instead of imputing the discount rate that way, I will just use the before-tax cost of debt, which is 2.04% (provided in 10-K).

The next step is to compute the present value of future operating lease payments. The excel spreadsheet below shows the arrival at that value.

		Discount Factor	
Year	Operating Lease Payment	0.024	Present Value
1	215,345,000	0.976563	\$ 210,297,959
2	186,309,000	0.953674	\$ 177,678,049
3	156,880,000	0.931323	\$ 146,105,952
4	138,832,000	0.909495	\$ 126,267,010
5	115,922,000	0.888178	\$ 102,959,370
Thereafter	115,922,000	4.233406	\$ 490,744,890
			<u>\$ 1,254,053,231</u>
Remaining Life = $\$593,784,000 / 115,922,000 =$			5.122272 years
PV of Sum Discount Factor = $1 / ((1+i)^t)$			
PV of Annuity Discount Factor = $((1 - (1 / ((1+i)^t))) / i) * (1 / ((1+i)^5))$			

To show what the financials would have looked like had the leases been capitalized, I will first add the \$1,254,053,231 to both NOA and NNO to represent the leased asset and the lease obligation.

Next, I will make the necessary adjustments to NOPAT, by deducting the operating lease payment, \$215,345,000 from the operating expense. Also, I will add the depreciation expense from leased assets to operating expenses. That depreciation expense amount would be $1,254,053,231 / 10 \text{ years} = \$125,405,323$. The 10 years was arrived at by adding 5 and 5.122272 (rounded down). Those two adjustments would affect NOPBT. The tax on operating profit would change as well. The change would be due to a change in the tax shield. For the tax shield, the statutory tax rate will remain the same, but pretax net nonoperating expense will need to be adjusted, which should be done by adding interest expense of \$30,097,278 ($\$1,254,053,231 * .024$). The tax expense would be different too, but

I do not have enough information to determine by how much. For the purposes of this calculation, I will use what the tax expense was as is.

NOPAT is now 765,737.62 (in thousands) as opposed to 687,234.48.

RNOA is now **0.17** as opposed to 0.21.

NOPM is now **0.19** as opposed to 0.17.

NOAT is now **0.88** as opposed to 1.17.

FLEV is now **0.71** as opposed to 0.24.

There are several reasons managers prefer to structure lease contracts as operating rather than as capital leases. By structuring a lease as an operating lease as opposed to a capital lease, the company avoids having to report the lease asset and related lease liability on the balance sheet. Consequently, non-operating asset turnover is higher and financial leverage is improved. Additionally, the portion of ROE derived from operating activities appears higher, which improves the company's perceived ROE quality. Finally, not having a lease asset or liability means no depreciation or interest expense – only rent expense. During the earlier years of the lease term, rent expense is less than what interest and depreciation expenses would have been, meaning a higher net income in those years.

Weighted Average Cost of Capital (WACC)

WACC consists of two components: cost of equity capital and cost of debt capital. In order to calculate cost of equity capital, the following model can be used:

(CAPM): $r(e) = r(f) + \beta[r(m) - r(f)]$ where β is the beta of the stock (an estimate of variability), $r(f)$ is the risk free rate, and $r(m)$ is the expected return to the entire market.

Assume a beta of 2.09 (yahoofinance.com).

Also assume the following market factors:

Risk-Free interest rate = 2.5%

Equity Spread $[r(m) - r(f)] = 6\%$

(CAPM): $r(e) = .025 + 2.09(.06) = .1504$ or 15.04 percent

The next component of WACC – cost of debt capital – can be found one of two ways: 1) by dividing the interest expense by average interest-bearing debt, or 2) the weighted average effective interest rate on debt, which can be found in the 10-K.

A weighted average effective interest rate on debt of 2.04 percent was specified in the 10-K.

Next, I will convert this value to an after-tax cost of debt by multiplying it by one minus the effective tax rate, which is 35.3%.

$2.04 * (1 - .353) = 1.32\%$

WACC is the weighted average of the cost of equity capital and cost of debt capital.

Equity Weight = Stockholders' Equity / (Stockholders' Equity + Total Debt)

Equity Weight = \$2,733,968,000 / (\$2,733,968,000 + \$2,018,383,000) = 57.5%

Debt Weight = 1 – Equity Weight

Debt Weight = 42.5%

Accordingly, WACC equals:

$$[57.5\% * r(e)] + [42.5\% * r(d)] =$$

$$[57.5\% * 15.04\%] + [42.5\% * 1.32\%] =$$

9.21%

Growth Forecast and Re-casted Financials

Tiffany's sales growth rates have been as follow for the past five years:

13.9 percent from 2009-2010

18.1 percent from 2010-2011

4.2 percent from 2011-2012

6.2 percent from 2012-2013

Based on a slowing sales growth rate the past two years, I am conservatively going to estimate a consistent 5.4 percent sales growth over the next four years.

This is my forecast:

	Reported	Forecasted				
	2013	2014	2015	2016	2017	Terminal Period
(in millions)						
Sales Growth	6.2%	5.4%	5.4%	5.4%	5.4%	1.0%
NOPM	0.19					
NOAT	0.88					
Sales	4,031,130,000	4,248,811,020	4,478,246,815	4,720,072,143	4,974,956,039	5,024,705,599
NOPAT	765,737,620	807,274,094	850,866,895	896,813,707	945,241,647	954,694,064
NOA	4,706,370,000	4,828,194,341	5,088,916,835	5,363,718,344	5,653,359,135	5,709,892,726

Stock Value Per Share with DCF and ROPI models.

The DCF valuation of common stock requires 5 steps:

1. Forecast and discount free cash flows to the firm (FCFF) for the horizon period.
2. Forecast and discount FCFF for the post horizon period, the terminal period.
3. Sum the present values of the horizon and terminal periods to yield firm value.
4. Subtract the value of the firm's debt (NFO) from the value of the firm.
5. Divide this amount by the number of shares outstanding to yield the estimated per share stock price.

	Reported	Forecasted				
	2013	2014	2015	2016	2017	Terminal Period
(in millions)						
Sales Growth	6.2%	5.4%	5.4%	5.4%	5.4%	1.0%
Discounted Cash Flow Model:		1	2	3	4	
FCFF (in thousands)	-92,129	-97,104	-102,347	-107,874	-113,670	-114,837

Discounted Cash Flow Model:		1	2	3	4	
FCFF (in thousands)	(92,129)	(97,104.00)	(102,347.00)	(107,874.00)	(113,670.00)	(114,837)
Discount Factor		0.915667	0.838446	0.767738	0.702992	
PV of Horizon FCFF		(88,915)	(85,812)	(82,819)	(79,909)	
Cum. PV of horizon FCFF	(337,455)					
PV of terminal FCFF	(1,398,745)					
Total firm value	(1,736,201)					
Less NNO	1,976,933					
Firm equity value	(3,713,134)					
Shares outstanding	128,312					
Stock value per share	(28.94)					
Trading price	83.19					

Because the FCFF is negative (Cash outflows from investing activities exceed cash inflows from operating activities) the DCF flow model is invalid and predicts a negative stock price, which is infeasible.

The ROPI model also involves 5 steps:

1. Forecast and discount ROPI for the horizon period.
2. Forecast and discount ROPI for the terminal period.
3. Sum the present values of the horizon and terminal periods.
4. Subtract NNO from firm value to yield firm equity value.

5. Divide firm equity value by the number of shares outstanding to yield stock price.

	Reported	Forecasted				
	2013	2014	2015	2016	2017	Terminal Period
(in millions)						
Sales Growth	6.2%	5.4%	5.4%	5.4%	5.4%	1.0%
NOPM	0.19					
NOAT	0.88					
Sales	4,031,130,000	4,248,811,020	4,478,246,815	4,720,072,143	4,974,956,039	5,024,705,599
NOPAT	765,737,620	807,274,094	850,866,895	896,813,707	945,241,647	954,694,064
NOA	4,706,370,000	4,828,194,341	5,088,916,835	5,363,718,344	5,653,359,135	5,709,892,726
Residual Income Model:		1	2	3	4	
Required Return		433,456,677	444,676,699	468,689,241	493,998,460	520,674,376
ROPI		373,817,417	406,190,196	428,124,467	451,243,188	434,019,687

Residual Income Model:		1	2	3	4	
Required Return		433,456,677	444,676,699	468,689,241	493,998,460	520,674,376
ROPI		373,817,417	406,190,196	428,124,467	451,243,188	434,019,687
Discount Factor		0.915667	0.838446	0.767738	0.702992	
PV of Horizon ROPI		342,292,272.77	340,568,545.08	328,687,422.05	317,220,351.22	
Cum. PV of horizon ROPI	1,328,768,591					
PV of terminal ROPI	5,286,476,090					
Total firm value	6,615,244,681					
Less NNO	1,976,933,000					
Firm equity value	4,638,311,681					
Shares outstanding	128,312,000					
Stock value per share	36.15					
Trading price at 1/31/2014	87.44					
Current trading price	89.08					

Chapter 9: Developing Tax and Audit Recommendations

How Management Assertions Affect Each Major Balance Sheet Account

See graphic below

Balance Sheet Account	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure
Cash and cash equivalents	Cash is physically present	All cash is accounted for; petty cash; checking and savings accounts, etc.	Company has right to cash that is physically owned	Current assets so stated at FMV	Banks where money is held
Accounts receivable, less allowances	Outstanding receivables	All A/R are assigned to correct period	Right of the organization to future cash due from past transaction	Stated at net realizable value	Allowance method described; shown at net amount

Inventories	Inventories listed on the balance sheet exist	Company not liable to reassume title	Clear title to; Can use at own discretion	Appropriate cost flow assumption; stated at lower of cost or market	All methods disclosed
Prepaid expenses and other current assets	All prepaid expenses have been recorded in the financial statements	Full amounts are included; adjustments/ accruals have been made	Right to use in the future	Expensed as used up	Prepaid expenses have been properly classified, described, and disclosed
Property, plant, and equipment	They exist	All transactions reflected in this period's balance	Owned by Tiffany & Co.	Recorded in accord with GAAP	Expected lives

Long term deferred income taxes	Exist at balance sheet date	All current year tax amounts have been recorded in financial statements	Current year tax amounts represent assets and liabilities of Tiffany at balance sheet date	Current year tax amounts have been recorded at their proper amounts and reflect all events and circumstances that affect their underlying valuation in accordance with GAP	Disclosed, described, and classified
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Short-term borrowings	Only valid short term-debt representing amounts due to lenders under enforceable borrowing agreements have been recorded	All short-term debt has been included in the financial statements	Represent Tiffany & Co. liabilities	Calculated correctly	Properly classified, described, and disclosed
Incomes taxes payable	Current year tax amounts exist at balance sheet date	All current year tax amounts have been recorded in the financial statements	Represent Tiffany & Co. liabilities	Calculated correctly	Properly classified, described, and disclosed

Accounts payable and accrued liabilities	Accounts payable balances representing liabilities that have been incurred and have not been discharged or settled, exist at the balance sheet date	Accounts payable and accrued liabilities include all obligations to vendors, employees, and other external organizations for the period	Accounts payable represent liabilities owing by Tiffany & Co. at the balance sheet date	Recorded at their proper amount to reflect amounts due to suppliers	Properly classified, described, and disclosed
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Long-term debt	Only valid long term-debt representing amounts due to lenders under enforceable borrowing agreements have been recorded	All long-term debt has been included in the financial statements	Obligations of the client	Recorded at proper amounts and reflected all events and circumstances that affect their underlying valuation in accordance with GAAP	Properly classified, described, and disclosed; terms of debt included
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Pension/ postretirement benefit obligations	Benefit plan amounts exist at balance sheet date	Benefit plans have been recorded	Client responsible for substantially all the risks and is entitled to substantially all the rewards arising from ownership of pension, post- retirement and other benefit plans	Recorded at proper values	Properly classified, described and disclosed
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Commitments and contingencies	All contingencies and commitments have been identified and recorded in the financial statements	All commitments and contingencies have been correctly identified at the balance sheet date	Responsible for all risk and entitled to all awards	Recorded at proper amounts and reflected all events and circumstances that affect their underlying valuation in accordance with GAAP	Contingencies not reported in financial accounts are properly disclosed in footnotes
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Two areas of audit risk and describe how I might design tests to address each of these concerns.

Two areas of audit risk of particular importance to a retailer like Tiffany & Co. are inventory and accounts receivable. In order to test all 5 management assertions relating to inventory, as an auditor I would perform the following tests:

Cut-off test: Take a sample of additions to inventory (purchases) and vouch them to purchase requisitions and receiving reports.

Observe the physical inventory count: Be familiar with the procedures used to conduct the inventory count. Perform some part of the physical inventory count myself.

Reconcile the inventory count to the general ledger: Trade the valuation compiled from the physical inventory count to the general ledger, to verify that the counted balances was carried forward.

Test for lower of cost or market: Compare a selection of market prices to their recorded costs.

Test item costs: Compare the amounts in recent supplier invoiced to the costs listed in the inventory valuation.

Test error-prone items: Test items for which there have been any error trends in the past.

Test high-value items: Tiffany maintains high value inventory items. An an auditor, I would spend extra time evaluating the inventory that's of particularly

high value.

For the second area of audit risk, accounts receivable, I would perform the following tests:

Trace receivable report to general ledger:

The first thing I would do would be to reconcile the accounts receivable subsidiary ledger to all the customers that owe Tiffany & Co. money to the total amount shown on the balance sheet, while confirming that uncollectible accounts have been written off correctly. Some tests I might perform include:

Positive confirmation- Ask that a customer sign and mail a form back to us attesting to the fact that the figure owed is correct or correcting it.

Negative confirmation- Customer reply only if amount incorrect.

As well, I might compare the prior year's uncollectible amounts with the amount estimated for the audit year to see whether bad debt is increasing or decreasing.

I'd also look through customer files to find out what action was taken to verify that accounts were in fact uncollectible.

How Internal Controls Might Provide Comfort to Auditors

Some internal controls that if properly implemented, would provide much comfort Tiffany & Co's external auditors include:

1. Establish responsibilities
2. Maintain adequate record

3. Insure assets and bond key employees
4. Separate record keeping from custody of assets
5. Divide responsibilities for related transactions
6. Apply technological controls
7. Perform regular and independent reviews

Establishing procedures to ensure the internal control requirements listed above are fulfilled with increase auditor's confidence in the existence, completeness, rights/obligation to, proper valuable or allocation, and correct presentation and disclosure of balance sheet accounts, and consequently revenues and expenses.

Corporate Tax Rates in Countries Tiffany & Co. Operates In

U.S. - when taxable income is over 18,333,333: 35%

Canada - 15% + provincial/ territorial income tax rate

Brazil - 15%

China - 25% (however, there are some reductions)

Korea - 10% on the first 200 million Korean won, 20% for between 200 million and 20 billion

Hong Kong - 16.5 %

Taiwan - 17%

Australia - 30%

Singapore - 17%

Macau- 3-9% below or equal to MOP 300,000 AND 12% over MOP 300,000

Malaysia - 25% (for non resident company)

Japan - Paid in capital over 100 million JPY: 25.5%, First JPY 8 million: 15%,

Over JPY 8 million: 25.5%

U.K. - 30%

Germany - 15%

Italy - 27.5% + 3.9% regional production tax

France - 33.3%

Spain - 28%

Switzerland - 8.5%

Austria - 25%

Belgium - 33.3%

Czech Republic - 15%

Ireland - 12.5% (standard rate)

Netherlands - 25%

The corporate tax rates in all of the other major countries where Tiffany & Co. earns revenue are lower than the federal statutory tax rate in the U.S.

Tax Credits Common Within the Retail Industry

Some tax credits a retailer might take advantage of include:

- Research and Experimental

- While most retailers generally do not deal in basic research, development, or experimentation of new products, some have

claimed research credit related to computer software and other research activities.

- Investment Credit

- An energy credit is an example of an investment credit. Many retailers look for energy efficiencies when remodeling or building new stores.

- Work Opportunity Tax Credit

- Meant to induce employers to hire members of families receiving benefits under the Temporary Assistance to Needy Families program and other similar groups.

- New Markets Tax Credit

- Created to spur investment in low-income or economically disadvantaged areas.

- Empowerment Zone Credit

- Focused on the creation of self-sustaining long-term development in distressed urban and rural areas.

- Indian Employment Credit

- Provides businesses with an incentive to hire individuals who live on or near an Indian reservation.

(IRS.gov)

Tiffany and Co., however, does not take advantage of any of these aforementioned tax credits. The only tax credit Tiffany & Co. seems to take

advantage is a foreign tax credit. There is no further elaboration of the foreign tax credit in the 10-K other than its existence. However, a foreign tax credit is a provision to mitigate potential double taxation. As Tiffany & Co. operates in numerous countries (see above), a foreign tax provision would be sensible.

Recommendation for Management

Investment credits are popular type of tax credit within the retail industry. The most common type of investment tax credits are energy investment credits. A value of utmost importance to Tiffany & Co., as highlighted on their website, is their corporate responsibility to be committed to maintaining “the highest standards of social and environment responsibility.” Part of that commitment involves reducing energy use and greenhouse gas emissions to protect future generations from the impact of climate change. Efforts to be more energy efficient have already been made: their corporate offices in New York City were consolidated according to the LEED green building certification program. These offices are LEED certified to the Platinum level, the highest level possible. They have also implemented other initiatives to reduce energy use in their manufacturing and distribution facilities. As one example, they have installed solar arrays. However, efforts have been primarily focused in the United States. I believe that if Tiffany & Co. were to focus their energy conservation efforts globally, a strategy that is consistent with their corporate values, they could potentially minimize their worldwide tax expense from the benefits of energy

investment tax credits. The credit for solar energy investments is equal to 30 percent of expenditures, with no maximum credit. Eligible solar energy property includes equipment that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat.

Chapter 10: Developing Advisory Recommendations

Three Recommendations to Increase the Bottom Line

1.) Focus on Profit & 2.) Positioning

My first two recommendations are intertwined. Tiffany & Co., has, like most retailers, suffered from the age-old retailer plague: a focus on top line growth at the expense of bottom line health. A drive to expand product lines and consumer markets has stretched Tiffany & Co. thin. While these methods do drive up revenue, they sharply cut into gross margin. In its history, Tiffany's has dealt with this issue. The company went through a sort of "identify crisis" when they tried to compete with department stores in selling low-margin watches, china, and glassware. According to a Newsweek article, "the Fifth Avenue store had stocked so many inexpensive items that it began looking like Macy's during a white sale, and that customers had complained about declining quality and service (IDCH). By making the Tiffany & Co. brand accessible to individuals willing to spend \$100-\$200 on a piece of jewelry, the firm has dramatically expanded its market share. However, the strategy of opening stores that focus exclusively on lower price point items may dilute the brand beyond repair, ultimately hurting long term sales (Economics-files). According to Tiffany's management, their single most

important asset is their “brand.” They should position their products so as to maintain that brand. When it comes to luxury retail, cognitive psychology is key. There are several theories that exist in regards to luxury retail marketing. Maintaining a sense of uniqueness and rarity to Tiffany’s products is essential, as well as developing anticipation for its product offerings. Other measures should be taken to maintain Tiffany’s “brand” and the Tiffany experience. Even during tough times, Tiffany should do their best to remain true to their identified strategy of being a product differentiator (Business Insider).

3.) Improve Commodity Management through Technology

A third recommendation that I have for Tiffany & Co. is to improve their commodity management, which I believe can be achieved through the use of technology. One risk factor as identified in their most recent annual report is the change in costs of diamonds and precious metals and reduced supply availability:

" A significant change in the costs or supply of these commodities could adversely affect the Company's business, which is vulnerable to the risks inherent in the trade for such commodities. A substantial increase or decrease in the cost or supply of raw materials and/or high-quality rough and polished diamonds within the quality grades, colors and sizes that customers demand could affect, negatively or positively, customer demand, sales and gross profit margins ... If trade

relationships between the Company and one or more of its significant vendors were disrupted, the Company's sales could be adversely affected in the short-term until alternative supply arrangements could be established.”

In short, Tiffany’s attempt to fix gross margin issues due to volatile/high commodity prices through increased prices has driven away potential customers and potential profit.

Successfully managing their diamond sourcing is essential. Current Commodity Trading and Risk Management (CTRM) technologies exist and may be beneficial for Tiffany & Co. to invest in.

CTRM addresses issues like big data, regulatory intervention, structural changes in the industry in terms of players, liquidity, instruments, cleared vs. non-cleared, exchange vs. OTC. CTRM is becoming more about just in time analytics, providing users with the tools that they need not just to manage and report transactions but also to help determine trading opportunities, address operational risks, ensure compliance with regulations and provide trading intelligence. CTRM can help with

- Improving regulatory reporting capabilities,
 - Broadening capabilities in supply chain management and optimization
 - Incorporating and/or improving trading intelligence and predictive analytics,
- and,

- Improving data aggregation and analysis

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